

INTERNAL REVENUE SERVICE

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The Honorable Tim Hutchinson
United States Senator
2527 Federal Building
Little Rock, Arkansas 72201

Dear Senator Hutchinson:

Commissioner Rossotti has asked me to respond to your inquiry dated January 21, 2000, on behalf of your constituent, Ms. [REDACTED] of [REDACTED], Arkansas, concerning the income tax treatment of a \$ [REDACTED] immediate cash payment she received from [REDACTED] following the crash of [REDACTED]. Ms. [REDACTED] has indicated that she sustained physical injuries in the crash, but that the injuries were not significant in nature.

Section 104(a)(2) of the Internal Revenue Code, as amended by § 1605 of the Small Business Job Protection Act of 1996 (the "1996 Act"), generally excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal physical injuries or physical sickness.

Section § 104(a)(2) and the legislative history of the 1996 Act amendments do not define the terms "physical injury" or "physical sickness," but it is clear that any injuries to the body, including cuts, scrapes, bruises, and other such bodily harm, would be included in the term "physical injury." It is also clear that all damages that flow from a claim based on a physical injury or physical sickness, including payments for emotional distress, are excludable from gross income and thus not subject to tax. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 301 (1996). Therefore, a claimant who suffers relatively minor physical injuries may nonetheless exclude all damages (other than punitive damages) that are received as a consequence of those injuries.

Section 1.104-1(c) of the Income Tax Regulations defines "damages received (whether by suit or agreement)" as an amount received through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Case law under § 104(a)(2) indicates that a settlement agreement contemplates disposition of an actual claim; in other words, although a settlement agreement may be oral or written, it is a contract in which the parties agree to terminate or forestall all or part of a lawsuit. Taggi v. United States, 35 F.3d 93 (2nd Cir. 1994); Aschkenasy v. Internal Revenue Service, 96 Civ 1932 (S.D.N.Y. 1998). An important factor in determining whether amounts received under a settlement agreement provide compensation for physical injuries, emotional distress, or other

purposes (e.g., reimbursing property losses) is the payor's intent in making the payment. Knuckles v. Commissioner, 349 F.2d 610 (10th Cir. 1965).

We do not have sufficient facts to know whether the payment from [REDACTED] to Ms. [REDACTED] can properly be viewed as an informal settlement, or partial settlement, of her claim for damages based on the physical injuries she sustained in the crash. If the facts support that characterization, she would be entitled to exclude the entire payment from gross income. She would in any case be entitled to exclude that portion of the payment representing any medical or other out-of-pocket expenses she may have incurred by reason of the crash.

I hope this information is helpful. Please contact Sheldon A. Iskow, Identification Number 50-03546, at (202) 622-4920, if we may be of further assistance.

Sincerely,

Deputy Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Robert A. Berkovsky
Chief, Branch 2